

Some Bad News and Some Good News from Articles Three and Four

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Most organizers of panel discussions attempt to crowd far too much into the usual twenty minutes or so allotted to each speaker. In this the panel discussion at the January 1982 AALS Meeting by five of those engaged in drafting the Uniform Commercial Code, or the major revisions of 1956, 1972, and 1978, was not an exception. Yet it was a striking exception because this law journal gave each of the panelists the opportunity to follow the published transcript of their all too brief remarks with a somewhat more extended discussion of some instances where in that person's opinion the work done has operated satisfactorily and where it has not. True, as Soia Mentschikoff has stated, "a full story of the drafting would be at least a substantial book."¹

This Article is offered as a compromise between panel discussion and a book in the hope that it will not achieve the fate of most compromises, that is to suffer the slings and arrows of outraged comment from both sides of each issue discussed. In it we address four areas of apparent lack of clarity in Articles 3 and 4 (the bad news) suggesting an approach (the good news) that, if used by counsel and the courts, will lead to proper solutions in these areas and hopefully in other areas of less than limpid clarity.² The approach suggested will require some consideration of the interrelationship of Articles 3 and 4 both in the drafting and at the present time.

I. THE RELEVANT DRAFTING HISTORY

The senior author's connection with the work on the Code began shortly after discharge from the United States' Army in 1946.³ First came an appointment as Assistant Professor at the University of Pennsylvania Law School in Philadelphia and an acquaintance with William Draper Lewis and Herbert Goodrich, both of whom were deeply engaged in the work of the

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The authors gratefully acknowledge the assistance of Kenneth Marino and John Randell, when third year students at The Delaware Law School, in the research for this Article.

1. *See Reflections of a Drafter: Soia Mentschikoff*, 43 OHIO ST. L.J. 537 (1982).

2. Admittedly, the law of Commercial Paper and Bank Collections speaks a separate language. It also deals with complex procedures, and often with several parties in the transaction chain from the issue of an instrument to the ultimate accomplishment of its purpose. In each case counsel must make clear to the court the purpose to be served by the instrument and the impact of each solution urged to the court on the entire burden of the processing of all instruments serving the same function.

3. Prior to Army service, the senior author had been for four years an associate in a firm representing a large New York bank. From 1950 to 1968, he was a partner in two Philadelphia firms engaged in the practice of financial law. The senior author, thus, was not entirely an academic.

American Law Institute. Largely through their combined efforts, Louis Schwartz, also on the Penn faculty, and the author were added to the drafting team late in 1947. Schwartz became the Reporter for Article 7, Documents of Title, and the author became Associate Reporter for Article 3 working with the urbane, witty, and learned Reporter, Professor William L. Prosser. Much input was also obtained from the brilliant and vigorous Karl N. Llewellyn as Chief Reporter and from the Associate Chief Reporter, Soia Mentschikoff. Later the bank collection material was taken out of Article 3 where the senior author was first instructed to draft it as a separate part. It became Article 4 and he was titled as Reporter.

Indeed, the bank collection material had rather a checkered career in the Code. After funding had been obtained, the committee of the National Conference of Commissioners on Uniform State Laws on "Co-operation with the American Law Institute in the Preparation of the Commercial Code" held a meeting in Philadelphia and approved preliminarily the following nine articles for the Code:

Article 1 - General Provisions, Including Definitions.

Article 2 - Sales.

Article 3 - Commercial Paper.

Article 4 - Bank Collections.

Article 5 - Investment Securities.

Article 6 - Bills of Lading and Warehouse Receipts.

Article 7 - Chattel Security.

Article 8 - Commercial Agency.

Article 9 - Repealer and Effective Date.⁴

As we all now know, there were several changes in this outline as drafting progressed. Foreign Banking came and went while Commercial Agency simply went. Investment Securities stayed. A proposed part for the Chattel Security article on certificates of title for mobile vehicles came and went. Bulk Sales made a belated appearance as a separate article, having once been in Chattel Security. Bank Collections was made Part 7 of Article 3 in 1949, became a separate article again in 1950, and was eliminated from the Code at the joint meeting of the Commissioners and the Institute in May 1951.

Walter Malcolm, Esquire, of Boston, Massachusetts, working with the Associate Chief Reporter, now Dean Soia Mentschikoff, voluntarily redrafted Article 4, and conferred earnestly with those who opposed it in May. When the Commissioners and the Institute met jointly in September 1951, Mr. Malcolm succeeded in having Article 4 reinserted in the Code.

The drafting process itself was a rigorous exercise of meeting about six annual deadlines. Drafts were prepared by the Reporter, discussed, in the

4. This listing appears in a multigraphed and otherwise unidentified report entitled "The Uniform Commercial Code Project" in the fragmentary personal files of the senior author. The Report is annotated to the annual reports of the National Conference of Commissioners on Uniform State Laws from 1936 to August 1953.

case of Bank Collections with informal advisers, then with the Chief Reporter and Associate Chief Reporter before revision to meet the first deadline with the appointed advisers for the Article.⁵ Based on the discussion with the Chief Reporter, Associate Chief Reporter, and the advisers, a revised draft was prepared and presented to the Council of the American Law Institute in February of each year, thus meeting the second deadline.

Appearing before the Council was an undertaking more formidable than arguing before any court. Presided over by the courtly and courteous George Wharton Pepper, it was as if you were simultaneously pleading a case before a bench consisting of two state supreme courts, a panel of the United States Court of Appeals for the Second Circuit, and a legislative committee.⁶

Changes were thereafter made and a new draft was prepared for the third deadline, the presentation to the floor of the American Law Institute, after clearance of the revisions with the advisers and the Chief and Associate Chief Reporter. This second presentation occurred at the May Annual Meeting of that august body. Again changes were required.

Then the whole procedure repeated itself on the side of the Commissioners on Uniform State Laws with presentations to the Commercial Acts Section and the annual meeting of the Conference. The gap between the Section and the floor of the National Conference of Commissioners was not much more than a day or so as both usually met in September and at the same place.

How then did one go about preparing drafts to meet these deadlines? It was almost necessary, like *Lochinvar*, to mount one's trusty steed and ride off in all directions at once. Bank Collections had to meet the needs of two distinct very practical operations; first, there was the procedure for collecting checks and like items in bulk and second, the more individualized procedure for collecting other items largely not paid by bank payors. The Bank Collections portion of the Code, at least, had to be written, not for the lawyer, but for the operations divisions of the many, many banks in the country that were

5. The advisers for Bank Collections were: Professor William E. Britton, University of Illinois Law School; Judge John T. Loughran, Court of Appeals of New York; Willard B. Luther, Esquire, of Boston, Massachusetts; Professor Maurice H. Merrill, University of Oklahoma Law School; Wilbert Ward, Esquire, Vice President, The National City Bank of New York; and Judge John D. Wickham, Supreme Court of Wisconsin. These gentlemen were also the advisers for Article 3.

6. There were 53 members of the Council over the period of drafting up to 1950. They are listed in Uniform Commercial Code, Proposed Final Draft, Spring 1950, at 4-5. Among the judges were Augustus N. Hand (2d Cir.), Learned Hand (2d Cir.), Joseph C. Hutcheson, Jr. (5th Cir.), Thomas D. Thacher (N.Y. Ct. App.), John D. Wickham (Sup. Ct. Wisc.), and Charles E. Wyzanski, Jr. (D. Mass.). Among Senior Practitioners with a legislative committee approach were Earl G. Harrison (Pa.), William V. Hodges (N.Y.), Monte M. Leaman (La.), William Marbury (Md.), William A. Schnader (Pa.), Harrison Tweed (N.Y.), and Cornelius W. Wickersham (N.Y.). Joseph Barrett of Arkansas and Walter B. Malcolm of Massachusetts also participated in the reviews.

Commercial Paper was presented to the Council at its winter meetings in 1946 and 1947. With Bank Collection material added, there were further presentations to the Council in 1948, 1949, 1950, and 1951. After each such presentation there were adjustments for presentation at the Annual Spring Meetings of the American Law Institute and The Annual Summer Conference of the Commissioners. Each of these in 1948 and thereafter were called as joint meetings of the Institute and the Conference.

dealing with checks in the thousands under most stringent time tables. Thus, it was necessary to learn the facts of the operation in order to devise rules that would be operationally acceptable. Consequently, the author visited the scene of the operations—the transit departments of banks with substantial correspondent networks. One banker in particular was most helpful, James Kennedy, Operations Vice President of the Philadelphia National Bank. He gave generously of his time and suggested many ways in which the collection process could be conducted with greater speed and efficiency. His ideas were innovative, but the general approach of bank lawyers and other bankers was conservative with a strong penchant for maintaining the status quo.⁷

The Federal Reserve Banks appointed a committee of counsel headed by O. J. Schlaikjer of the Boston Reserve Bank. Several lengthy meetings were held with this group, but until the revision of September 1951 and the compelling advocacy of Walter Malcolm, their opposition, and that of counsel for the Chase Bank, was adamant. One cardinal policy of the two sponsoring organizations, the American Law Institute and the National Conference of Commissioners on Uniform State Laws, was to produce a Code that could be adopted by a large majority, if not all, of the states. To this end many compromises were made to eliminate opposition with strong legislative clout. Examples are not hard to cite. The certificate of title part of what later became

7. Witness the elimination of provisions for presentment by electronic means reading: "(3) If the original item follows within a reasonable time a collecting bank may make presentment to the payor bank in any substitute manner agreed between them, as by facsimile or other adequate demand." U.C.C. § 3-617(3) (May 1949 Draft). Comment 6 to the section stated, "Subsection (3) permits the use, by agreement, of an equally expeditious means of collection including electric facsimile transmission." Also eliminated was a provision for automatic returns requiring a collecting bank taking a cash item for collection to "(b) if the item is not paid return it or send notice of nonpayment to its transferor or, if its transferor has so agreed, have the item presented again or returned directly to the depository bank or to a prior intermediary bank." U.C.C. § 3-614(1)(b) (May 1949 Draft). The re-presentment was eliminated, but direct returns remains in a modified form. Also eliminated was a provision providing for the authorized use of a facsimile or transcript of a lost item. It read,

Section 3-639. Facsimile or Transcript of Lost Item.

(1) A purported photographic facsimile of an item or of its face has the effect of an original for purposes of completing a collection when accompanied by written statements by one or more banks that it is such a photographic facsimile of an item reported lost and, if only the face is photographed, that the item,

- (a) if a cash item was indorsed with the name of a bank as indorser or indorsee (Section 3-618)
- or (b) if an item which was not a cash item was not payable to bearer.

(2) A purported transcript of an item having a payor who is not a bank and accompanied by written statements by one or more banks that it is a transcript and that the item was not payable to bearer has a like effect.

(3) A bank issuing under this section a statement which is erroneous is liable up to the face amount of the item for any loss incurred by any party acting on its statement.

U.C.C. § 3-639 (May 1949 Draft).

The original attempt to provide separate rules for "cash" items travelling in the bulk collection channel and "non-cash" items collected in a manner more nearly item by item and often called "collection items" (see May 1949 Draft, §§ 3-603, 3-607, and 3-608) was also abandoned, except that a remnant may be found in section 4-302's different treatment afforded to missing the midnight deadline in its subsections (a) "accountable for the amount of the item whether properly payable or not" and (b) "accountable for a properly payable item."

Although the concept of "Direct Returns" remained in the Code to its final draft, it now appears in section 4-212(2) as an optional section. This treatment can be taken as indicating no need for uniformity. Its effect has been to stifle an optional practice as bankers do not know the effect of a failure to enact the section in the jurisdiction of a bank to be bypassed on its (the bank's) authority to agree to the procedure. The issue is largely when the credit for the direct return becomes final to the returning bank.

Article 9 was eliminated from the Code when the State Motor Vehicle Commissioners indicated leaving it in would result in their united opposition to this invasion of their turf.⁸ The exclusion of farm products from protection given to buyers in the ordinary course of business in 9-307(1) placated the Farm Credit Administration and the Grange.⁹ The insurance industry secured the exclusion of security interests in insurance policies¹⁰ and precipitated the struggle over whether the insurance monies were "proceeds" of the automobile or other equipment suffering a casualty loss.¹¹ The railroads were assuaged by the elimination of car-trust financing.

But it was clear that the Code affected the banking industry in so many ways that without its concurrence passage of a Code in most legislatures would be improbable, perhaps even impossible. One difficulty was that the bankers and their lawyers were not altogether united on what they would accept. The lawyers' approach was that they had learned to live with the present law, so why change it. The bankers wanted protection for the way they operated.

But the so-called "present law" was far from being coherent or organized, and it certainly was not uniform. Dean Frederick Beutel had identified over seventy-five instances under the Uniform Negotiable Instruments Law where, on identical problems, courts had taken differing opinions.¹² Various collection cases had been decided by applying concepts of purchase, agency, trust, tort, and contract law, but not in an entirely satisfactory manner. The theory producing a desired result in one situation often, if applied in another context, produced far from desirable results.¹³

While the drafter's goal was clear, the task of reaching it was not easy!

II. THE EXISTING LAW AVAILABLE TO THE DRAFTING TEAM

In 1949, there were miscellaneous statutes in various states, and certain non-uniform amendments to the Negotiable Instruments Law (NIL) that had a greater or lesser impact on both negotiable instruments and bank collections. We are now so used to direct forwarding to a payor bank that, to many today, it seems odd that statutes were needed in twenty-six jurisdictions to free this practice from placing a common-law liability on the forwarding

8. It appeared as an uncleared Reporter's Draft in the May 1949 Draft as Part 8 of the then Article 7, now Article 9. As a trial balloon, it was promptly shot down. It has, however, received some favorable comment. See C. CORMAN, *COMMERCIAL LAW, CASES AND MATERIALS* 737 n.12 (1976). The draft covered aircraft, watercraft, and vehicles.

9. The opposition continued and the suggestion of the 1972 revisers for its elimination was torpedoed then, also.

10. U.C.C. § 9-104(g) (1978).

11. Clarified by the 1972 Amendments to Article 9. U.C.C. § 9-306(1) (1978).

12. F. BEUTEL, *BRANNAN'S NEGOTIABLE INSTRUMENTS LAW* 89 nn.38-40 (7th ed. 1948).

13. See, e.g., the numerous cases cited as "rejected" in comment 2 to U.C.C. § 4-213. Bad case law on the effect of taking under a restricted indorsement holding there could be no holder in due course also had to be rejected. See U.C.C. §§ 3-205 and 3-206 (1978).

bank.¹⁴ At common law in New York, a depository bank was liable to its customers for the negligent action of its correspondents, with a right of action against that bank for reimbursement.¹⁵ But by 1949 the contrary "Massachusetts rule" of non-liability, except where the customer could show negligence in the selection of the correspondent, was thought to be in force in almost all states through statute, decision, or clauses in deposit contracts.¹⁶ Thirty-seven jurisdictions had statutes placing a time bar on customers for delay in making a claim on a forged drawer's signature on or an alteration of a check.¹⁷ Eighteen statutes addressed the problem of a bank's liability for non-payment of a customer's check through error.¹⁸ Statutes relieving a bank from any obligation to pay a stale check were on the books in twenty-five jurisdictions.¹⁹ Less widely adopted were statutes permitting the acceptance of a remittance draft of a bank in payment,²⁰ the payment of checks for a limited

14. The comment to section 4-204 indicates no prior uniform statutory provision, but refers to section 6 of the American Bankers Association's Bank Collection Code. See note 23 *infra*. Other statutes covering specific aspects of the process of collecting and paying checks were identified in the following passage from Leary, *Article 4: Bank Deposits and Collections under the Uniform Commercial Code*, 15 U. PITT. L. REV. 565 (1954):

In 1926 the situation was as follows: Forwarding check direct to payor act, adopted in 26 states but not in Pennsylvania, New York or Massachusetts; Non-payment of check through error act, adopted in 7 states, not including Pennsylvania, New York or Massachusetts; Payment of stale check act, adopted in 14 states, but not in Pennsylvania, New York or Massachusetts; Act placing time limit on depositors to report forged or raised checks, adopted in 31 states, but not in Pennsylvania; The act limiting depositors to actual damages where check dishonored through error, adopted in 18 states, but not by New York or Massachusetts; Nonliability of collecting bank for default of correspondents: 26 states had adopted the Massachusetts rule judicially or otherwise, but New York still adhered to the contrary rule, and 11 states had not passed on the question. To counteract the effect of the *Mallory* decision, 4 states had passed statutes allowing a collecting bank to accept exchange in lieu of cash, but not Pennsylvania, New York or Massachusetts. The above information is collected in 2 PATON'S DIGEST, Appendix pp. 59-69 (1926). Pennsylvania and New York and Massachusetts are selected for comment as the leading eastern commercial states.

Id. at 566 n.4.

15. Illustrative of the New York rule are *Allen v. Merchants Nat'l Bank*, 22 Wend. 115 (N.Y. 1839), and *Exchange Nat'l Bank of Pittsburgh v. Third Nat'l Bank*, 112 U.S. 276 (1884). The rule may be based on the theory of early cases that the depository bank had, by giving credit subject to a charge-back, purchased the item.

16. States adopting the Massachusetts rule by statutory enactment included Florida, Idaho, Illinois, Indiana, Kentucky, Maryland, Michigan, Minnesota, Missouri, Montana, Nebraska, New Jersey, New Mexico, New York, Oklahoma, Oregon, Pennsylvania, South Carolina, Washington, West Virginia, Wisconsin, and Wyoming. 2 PATON'S DIGEST OF LEGAL OPINIONS, *Collection* §§ 15:2, 27:1 (2d ed. 1942). States adopting the Massachusetts rule by decision or permitting its adoption by clauses in deposit contracts included Alabama, Colorado, Georgia, Oklahoma, Oregon, South Carolina, and Texas. *Id.* at § 15:3.

17. The jurisdictions were Alabama, California, Connecticut, District of Columbia, Florida, Georgia, Idaho, Illinois, Iowa, Kansas, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Dakota, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. *Id.* at *Forged Paper* § 9:1.

18. The states included Alabama, Arkansas, California, Idaho, Illinois, Maine, Michigan, Missouri, New Jersey, New Mexico, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Virginia, West Virginia, and Wyoming. 1 PATON'S DIGEST OF LEGAL OPINIONS, *Checks* § 21B:1 (2d ed. 1944).

19. The twenty-five jurisdictions were Alabama, Arkansas, California, District of Columbia, Florida, Georgia, Idaho, Kansas, Louisiana, Maine, Michigan, Missouri, Montana, Nevada, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, Utah, Vermont, Virginia, Washington, West Virginia, and Wisconsin. *Id.* at § 20:6.

20. Colorado, Minnesota, North Carolina, and Texas were the only four states with statutes authorizing this practice. 2 PATON'S DIGEST OF LEGAL OPINIONS, *Collection* § 19:6 (2d ed. 1942).

period after death,²¹ and placing time limits on the effectiveness of stop orders.²²

There were two prior attempts to codify the law relating to bank collections. One was the American Bankers Association Model Bank Collection Law adopted in some eighteen states,²³ but ruled unconstitutional in the case of the Illinois statute in view of the non-applicability of the preference provisions to national banks.²⁴ The other source was the draft of a proposed Uniform Bank Collections Law in the files of the National Conference of Commissioners on Uniform State Laws which had not been formally adopted by the Conference.²⁵

Finally, stemming from the war-generated increase in the number of items to be handled with the hand operated mechanical sorters, a new practice developed, that of deferred posting and delayed returns. This resulted in *ad hoc* statutes extending the bank's time to determine whether an item was properly payable until the expiration of the next day after the day of presentment. The statutes, some as amendments to the Bank Collection Act, some as amendments to the NIL, and some enacted as part of the banking law, existed in almost every state.²⁶

There were numerous decisions on other phases of the collection process giving results that were often quite surprising to those engaged in collecting items.²⁷

III. THE CODE PHILOSOPHY

The Commercial Code Project passed through two distinct phases. In the first phase there was to be a "tight" code which was to govern so that departures from Code rules by private contract could only occur in respect of those rules specified to apply "unless otherwise agreed." As late as the May 1950 draft, the Code contained a section 1-107 reading: "The rules enunciated

21. Statutory authorization for payment of checks after death existed in Connecticut, Florida, Maine, Massachusetts, New Jersey, Vermont, and Virginia. 1 PATON'S DIGEST OF LEGAL OPINIONS, *Checks* § 13:13 (2d. ed. 1942).

22. Statutory time limits on the effectiveness of stop orders were found in Alabama, California, Connecticut, Florida, Georgia, Iowa, Kentucky, Louisiana, Maine, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, Oregon, Pennsylvania, and Texas. 3 PATON'S DIGEST OF LEGAL OPINIONS, *Stopping Payment* § 5:3 (2d. ed. 1942).

23. The Bank Collection Code was sponsored by the American Bankers Association and adopted in Idaho, Illinois, Indiana, Kentucky, Maryland, Michigan, Missouri, Nebraska, New Jersey, New Mexico, New York, Oklahoma, Pennsylvania, South Carolina, Washington, West Virginia, Wisconsin, and Wyoming. See Steffen, *The Check Collection Muddle*, 10 TUL. L. REV. 537, 549 n.20 (1935).

24. *People ex rel. Barrett v. Amon Bank & Trust Co.*, 362 Ill. 164, 199 N.E. 272 (1935). Cf. *Jennings v. United States Fidelity & Guar. Co.*, 294 U.S. 216 (1935).

25. See, e.g., *Fifth Tentative Draft of Uniform Bank Collection Act*, HANDBOOK OF THE NAT'L CONF. OF COMM'RS ON UNIFORM ST. LAWS 160 (1931).

26. See, e.g., 1956 Ky. Acts ch. 47 and the discussion of pre-Code law under the caption "History of Payor Bank's Liability for Retaining Check" in *Blake v. Woodford Bank & Trust Co.*, 555 S.W.2d 589, 591-93 (Ky. 1977).

27. See, e.g., *Bohlig v. First Nat'l Bank in Wadena*, 233 Minn. 523, 48 N.W.2d 445 (1951); U.C.C. § 4-213, comment 2 (1978) (rejecting this and similar decisions).

in this Act which are not qualified by the words 'unless otherwise agreed' or similar language are mandatory and may not be waived or modified by agreement."

By the time the Spring 1950 Draft was reached, it was realized that, at least in the area of bank collections, the reverse approach would be required, and so Article 4's section 4-103 was included to emphasize the change in approach.²⁸ But even then the specified limitations on "freedom of contract" were considered too specific and too all-inclusive by the approving bodies.

The Spring 1951 draft again had four specifics that could not be varied by agreement.²⁹ But still "agreement otherwise" was not altogether satisfactory because the concept of "agreement" implied the consent of all affected parties. Quite possibly, the authority of agent collecting-banks to make agreements would have to be specific and move to the agent from the "owner" principal, not always an obtainable situation.³⁰

The 1952 Code then hit on the concept of vesting authority to make "agreements otherwise" in the Federal Reserve System and its regional banks, in view of the continued interest of that organization in speeding up the collection process and its representation of a governmental interest. To make clear the extent of the delegation, the relevant subsection concluded with "whether or not specifically assented to by all parties interested in the items handled."³¹

Then, to be sure of what would constitute the limits of "ordinary care" (since liability for failure to exercise ordinary care could not be disclaimed by agreement), subsection (3) of section 4-103 declared that action or non-action

28. Providing that it was operative "notwithstanding Section 1-107" and specifying complete freedom of "agreement otherwise" in its preamble, the section continued:

- (1) No agreement can limit a bank's liability to the customer of a depository bank
 - (a) for its own negligence or its failure to act within a reasonable time and with due diligence and good faith under Section 4-304 [on responsibility for collection] although the method of sending an item for presentment may be specified by agreement; or
 - (b) for authorization or ratification by a collecting bank of remittance in the form of a payor's own primary obligation; and
- (2) A time limit fixed by this Article cannot be extended by agreement except that a particular agreement between the affected parties may waive, modify or extend a time limit as to specified items; and

(3) No agreement can limit the obligation of a bank to stop payment under Section 4-202 [now 4-403] or the measure of damages when there is improper handling.
U.C.C. § 1-103 (Proposed Final Draft 1950).

Comment 1 to this section stated, that its purpose was "1. To provide necessary flexibility for the myriad types of instruments collected through banks and for the countless different situations that might arise by permitting the usual and normal rules to be varied by agreement, where basic responsibilities and definitions of terms are not altered." U.C.C. § 4-103, comment 1 (Proposed Final Draft 1950).

29. Although the section was substantially redrafted, placing the four items as (a), (b), (c), and (d) of § 4-103(1), subsection (4) of the Draft provided for the one day time extension now found in the U.C.C. § 4-108 (1978).

30. See, even today, the discussion of the apparent authority of an agent collecting bank in *David Graubart, Inc. v. Bank Leumi Trust Co.*, 48 N.Y.2d 554, 399 N.E.2d 930, 423 N.Y.S.2d 899 (1979), and note the following statement from that opinion: "To the extent that a payee deems itself aggrieved by a depository bank's ignoring of limitations on its authority, of which none are claimed here, the law provides recourse against it. . . ." *Id.* at 561, 399 N.E.2d at 934-35, 423 N.Y.S.2d at 904. Nor will a form deposit contract always give the protection desired by the depository bank. See the "interpretation" against the bank used in the District Court, *Eastern District of Pennsylvania in Cumis Insurance Society, Inc. v. Girard Bank*, 32 U.C.C. Rep. Serv. (Callaghan) 877 (E.D. Pa., 1981).

31. U.C.C. § 4-103(2) (1978).

approved by Article 4 or by Federal Reserve regulations or operating letters is, conclusively, the exercise of ordinary care.

Since clearing houses and regional clearing groups would constitute an amalgam of banks interested in receiving funds and in properly paying out funds, clearing house rules were also made effective as agreements otherwise. In view of the private nature of these organizations and of "general banking usages," these were only blessed as *prima facie* ordinary care.³²

So far as we are aware, there has been no attack on these provisions as unconstitutional delegations of state legislative power to non-state controlled sources. Nor do we mean to suggest that any such attack would be successful.

What has developed, however, is a small division of authority as to whether Federal Reserve regulations and operating letters apply to the processing of items not passing through the Federal Reserve Banks in their course of collection.³³ We suggest that there may be a difference between reliance on a Federal Reserve operating letter as an "agreement otherwise" in the case of an item not passing through a Federal Reserve Bank and a case where the issue is lack of "ordinary care." Since the basic liability of a collecting bank is only to exercise "ordinary care" in sending for presentment and in settling when receipt of a final settlement has occurred,³⁴ there is probably little or no difference between the two concepts—i.e., "agreement otherwise" and "exercise of ordinary care"—except when the issue involves, as it most often does, a variation in time limits imposed by the Code.

Under subsection (3) of section 1-204 of the Code, when time limits are couched in terms of "seasonably," it means that action must be taken "within the time agreed or if no time is agreed within a reasonable time." Thus the distinction could be that the item must pass through a Federal Reserve Bank or a particular clearing house for its rules to operate as agreements, but need not be so handled for the rules to operate as standards of ordinary care, and that time limits for taking action are within a reasonably longer time where a Code time limit so permits if taken within time limits specified by Federal Reserve rules, and *prima facie* so if taken in accordance with clearing house rules or a general practice.

IV. THE BAD NEWS (PROBLEMS) AND THE GOOD NEWS (METHODS FOR SOLUTIONS)

With that much historic background let us examine four of the icebergs in Articles 3 and 4 using the "good news" method. The "good news" method is really a process of Code interpretation. It involves, first of all, a recognition

32. U.C.C. § 4-103(3) (1978).

33. See, e.g., *Wells Fargo Bank v. Hartford Nat'l Bank & Trust Co.*, 484 F. Supp. 817 (D. Conn. 1980) (Banking custom, Federal Reserve regulations and operating circulars applied to items not sent through the Federal Reserve system). But see, e.g., *Krane v. American Nat'l Bank & Trust Co.*, 21 Ill. App. 3d 1036, 316 N.E.2d 177, 15 U.C.C. Rep. (Callaghan) 683 (1974) (Stating where item not sent through the Federal Reserve system Federal Reserve regulations are not applicable). See also *Community Bank v. Federal Reserve of San Francisco*, 500 F.2d 282, 14 U.C.C. Rep. (Callaghan) 1407 (9th Cir. 1974) (Banks are subject to Federal Reserve regulations on items sent by correspondents as long as they use Federal Reserve transit numbers).

34. U.C.C. § 4-202(1) and (3) (1978).

that, particularly with Articles 3 and 4, sections cannot be read in isolation from each other. Rather, by means of an often tedious process of "piecing together" various sections in light of the Code's history and philosophy, a clear interpretation can result without resorting to the perennial cry for re-drafting. Specifically, Code sections must be understood, at least in the case of bank collections, as attempts to remedy the mischief created by prior, non-uniform law. They must be further understood as attempts to support actual banking practices when dealing in bulk with large numbers of items since the need for speed in securing payment at a viable per item cost overrides time-consuming niceties of fiduciary theory.³⁵ On the other hand, when dealing with much smaller numbers of "other" items specially handled, a differing approach is feasible. Finally, the "good news" method takes note of the second philosophical phase described above—the power of banks to "agree otherwise" by complying with ordinary banking practices.³⁶ The reasonable character of these should be practically tested.

To demonstrate the approach that should be taken by counsel and court we next discuss, in some detail, four areas where we believe the approach is urgently required. First is the area of a mistaken payment by a payor bank. Second is the case of the second presentment of a previously dishonored item. Third, we consider the problem of suit by a drawer or payee directly against a collecting bank. Finally, we treat the problem of forgery by employees of a payee.

A. Recovery of Payments Made by Mistake of the Payor Bank.

There seems to be a difference of opinion between at least two commentators on whether a payor bank, which has, due to a mistake, knowingly allowed its process of posting to become completed, may recover the payment where the recipient is not within either of the two classes protected by section 3-418's doctrine of finality—that is, where the recipient is neither a holder in due course nor a person changing position in good faith reliance on the payment.³⁷

35. Current estimates place the number of cash items (almost exclusively checks) handled in a year at 40 billion, or about 160 million a day. The average check passes through 2.5 banks in the course of collection, giving 400 million handlings per day. Last year Bank of America N.T. & S.A. handled about two billion checks alone. See Leary, McCulloch, and Winship. Materials on the Law of Credit & Payment Systems (Commercial Paper) pt. 3, at 298 (unpublished teaching materials). See *Cooper v. Union Bank*, 9 Cal. 3d 371, 386, 507 P.2d 609, 620, 107 Cal. Rptr. 1, 12 (1973), for an example of use by the courts of similar statistics on an individual bank basis to determine the UCC section 3-406's applicable "reasonable commercial standards."

36. Consideration should be given to the number of items handled per hour, the problems of those waiting in line at a teller's window and the cost of the measures suggested by the court that should have been taken, and were not. The issue of compliance with "reasonable commercial standards" in the banking area arises in cases involving an item, or series of items, and the bank raises either a UCC § 3-406 or 3-419(3) defense, which the other party seeks to defeat by claiming a failure to observe "reasonable commercial standards." For the case in a UCC 3-406 defense, see, e.g., *Cooper v. Union Bank*, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973); *First Nat'l Bank of Boston v. Hovey*, 412 N.E.2d 889 (Mass. App. 1980). For a UCC § 3-419(3) situation, see, e.g., *Nat'l Bank of Georgia v. Refrigerated Transport Co.*, 147 Ga. App. 240, 248 S.E.2d 496 (1978).

37. The differing views are on one side expressed in J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 16-2, at 613-18 (2d ed. 1980), and on the other side, in addition

The difference of opinion arises over a language difference between sections 4-213 and 4-302. In the latter section, which provides the liability for not observing the midnight deadline, a difference is made between "demand items other than documentary drafts" and "other items." The difference between the two is that in the case of "demand items" a penalty type liability applies. The payor bank is accountable whether or not there are sufficient funds in the drawer's account. In the case of the "other" item, there is liability *only* if the item is, in fact, "properly payable," i.e., there were sufficient funds in the account when the midnight deadline expired. The section has a preamble reading: "In the absence of a valid defense such as breach of a presentment warranty (subsection (1) of Section 4-207), settlement effected or the like. . . ." The language of section 4-213(1) has no such clause in its preamble, which reads: "An item is finally paid by a payor bank *when* the bank has done any of the following, whichever happens first . . ." (emphasis supplied). The four instances of final payment then follow: paid in cash, settled non-provisionally, completed the process of posting, or missed revoking a provisional settlement as permitted by clearing house rule, agreement, or statute including the Code.

The liability under both 4-302 and 4-213(1) is stated as becoming "accountable for the amount of" the item. Prior drafts had used "recover . . . the amount of an item"³⁸ or "is liable . . . for improper handling,"³⁹ which, by definition, permitted the bank to reduce a recovery by any amount it could show would not have been collected had there been proper handling.⁴⁰

to those of the senior author, are found the views of John D. Colombo in *Commercial Paper & Forgery: Broader Liability for Banks*, 1980 U. ILL. L.F., 813. In this piece, the author approaches the dispute from the angle of proper rules of statutory interpretation and concludes that the position taken by Professors White and Summers is "simply untenable." The senior author is inclined to say smilingly that he does not "find any great virtue in Professor White's ideas." Cf. J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* 702 (2d ed. 1980).

38. The Spring 1950 Draft provided:

(1) Unless the customer of the depositary bank has broken a presentment warranty he may *recover* as if a depositor in the payor bank

(a) *the amount of an item* presented by mail or through a clearing house whether properly payable or not if the payor bank either retains it beyond midnight of the banking day of receipt without settling therefor or having settled does not return the item or send notice of dishonor until after its midnight deadline.

U.C.C. § 4-402(1)(a) (Spring 1950 Draft) (emphasis added).

39. The May 1949 Draft provided: "(4) A payor bank which dishonors a properly payable item presented by mail or through a clearing house is liable to the holder and to all parties for improper handling." U.C.C. § 3-629(4) (May 1949 Draft) (emphasis added).

40. In the May 1949 Draft the same rule was placed on recoveries from a payor bank that applied (and still applies) to actions against a collecting bank. This was done in section 3-641 of the Draft. Subsection (1) read, "(1) A bank failing to handle an item in accordance with this Part is liable to any prior party for the amount of the item, reduced by any amount which could not have been realized by proper handling, and is also liable for consequential damages where there is bad faith in the handling."

Two further subsections placed full liability on a bank transferring a cash item to a person not a bank and out of the course of collection, and for items that would have been paid if the bank had not given its own set-off an improper preference. This was because the bank was supposed, in this Draft, to pay items on a "day blockage" basis, that is, items received on a Monday were to have priority over Tuesday's receipts and

The concept of "accountability" was introduced in the Spring 1951 draft. In this draft the term "accountable" first appears, and was, and still is, described in the comments as follows:

It is not made accountable if it has paid the item in cash because such a payment is itself a sufficient accounting. The term "accountable" is used as imposing a duty to account, which duty is met if and when a settlement for the item satisfactorily clears. The fact that *determination of the time of final payment* is based exclusively upon action of the payor bank is not detrimental to the interests of owners of items or collecting banks because of the *general obligations of payors to honor or dishonor* and the time limits for action imposed by Sections 4-301 and 4-302.⁴¹

Those fearless commentators, Messrs. White and Summers, take the position that since there is no reservation of defenses under section 4-213 and since Article 4 governs Article 3 in the case of conflict, then once a bank has made final payment it is not recoverable.⁴² Their analysis seems to us to neglect several factors, in addition to a proper determination of whether a conflict really exists, namely:

- a. Voluntary payment does not prevent recovery for breach of a presentment warranty.
- b. The comment describes the function of section 4-213 as fixing the *time* when final payment occurs and the resulting accountability, not the effect of being accountable.⁴³
- c. The comment refers to sections 4-301 and 4-302 as setting forth the general obligation of payors to honor or dishonor.⁴⁴
- d. The comment refers to "accountable" as imposing a duty to account.⁴⁵ In actions for an accounting the one subject to the duty to account can always obtain the benefit of any viable defenses to liability that may exist.
- e. It makes no sense to penalize one who has performed his or her general obligation to pay by imposing a more drastic penalty than is fixed for a failure to perform the obligation.

So, even if we feel that a payor bank's right to recover a payment is to be equated to the listing of defenses to accountability in section 4-302, the answer is not altogether free from some slight ambiguity. The preamble to

Tuesday's set-offs. The rules as to this were placed in a section captioned "Contract of Drawee with Drawer." The section contained many rules now found only in Article 4, such as right to charge the account, a stale check rule of six months, and was followed by sections on stopping payment and wrongful dishonor. It made some rules applicable to all drawees and others only to payor banks. It contained the first draft of what is now section 4-407 on subrogation rights.

41. U.C.C. § 4-213, comment 7 (1978) (emphasis added). The word "accountable" came from the then existing New York deferral statute.

42. See note 37 *supra*.

43. See U.C.C. § 4-213, comment 1, stating, "Subsection (1) of Section 4-213 defines *when* settlement for an item or other action with respect to it constitutes final payment." (Emphasis supplied).

44. U.C.C. § 4-213, comment 7 (1978).

45. U.C.C. § 4-213, comment 9 (1978).

section 4-302 also requires careful reading. It states, "in the absence of a valid defense such as . . .," thereby indicating that the listing that follows is not complete. Then three items are listed:

- a. Breach of a presentment warranty;
- b. Settlement effected;
- c. Or the like.

What can be "like" the two such different particularizations? Even to apply a construction *ejusdem generis*, a "like" to breach of presentment warranty must be taken to mean, "If I had paid you, I could sue and get it back." The "like" to "settlement effected" means, "You already have the money." Hence any set of facts permitting recovery of a payment should be included within the scope of "such as . . . or the like."

Therefore, we suggest that the correct analysis can be found in the opinion of the court in the New Jersey case of *Demos v. Lyons*,⁴⁶ namely, that section 4-213, as its comment states, merely details the "time when" final payment and the "duty to account" arises. Nothing in section 4-302 precludes the assertion of a right of recovery of money paid under mistake of fact, if the action is a viable one. But section 3-418 prevents such recovery against two classes of recipients. These are holders in due course and those changing their position in reliance on the supposed receipt of payments. Recovery of a "mistaken" payment from a recipient who is in neither of the classes protected by section 3-418 should be allowed as coming within the scope of the preamble to section 4-302. Such an interpretation does not fly in the face of any purpose or policy of section 4-302, which was designed to penalize delays in and failures to complete the process of payment.⁴⁷ A cause of action for payment under mistake of fact requires proof that the recipient is neither a holder in due course nor one who has changed position in reliance on receipt of a final payment. The action also requires proof of a conscious payment, not a negligent disregard of the midnight deadline. It also requires proof that the payment was induced by a state of mind not in accord with the facts creating the obligation to pay.⁴⁸ There is nothing in the policy underlying Article 4 that requires an abandonment of the limitations on the broad scope of *Price v. Neal*⁴⁹ drafted into the Code by section 3-418.

There is no good reason why a collecting or presenting bank should receive a "windfall" at the expense of the payor bank when such bank cannot qualify as a holder in due course or show detrimental reliance. The "tight

46. 151 N.J. Super. 489, 376 A.2d 1352 (1977).

47. This was the price exacted by the Federal Reserve System for going along with the extra time allowed under the deferred posting statutes, namely, that a provisional payment be made on the day of receipt, with a right of immediate recovery in the case of prompt action.

48. See the definition of "mistake" in RESTATEMENT (SECOND) OF CONTRACTS § 151 (1981).

49. 3 Burr 1354 (1762). A position substantially similar to that taken in this Article is taken by Colombo, *Commercial Paper & Forgery: Broader Liability for Banks*, 1980 U. ILL. L.F. 813.

reading” of the liability attached to the midnight deadline suggested by White and Summers fails to recognize phase two in the philosophy behind Articles 3 and 4.⁵⁰

B. *Absence of Provision Covering Re-Presented Items*

A practice existed in 1948 and 1949, but was not widespread, of re-presenting checks returned N.S.F. (Not Sufficient Funds). In most instances at that time they were returned, not as cash items, but as collection items. In some instances today they are returned on an almost automatic basis by depository banks. Some banks still return them as collection items, others include them in cash letters, apparently, and may not notify the customer, nor specially signal the payor bank. Such second presentments could be analyzed in one of three ways, namely:

- a. The item is a “demand item” still and is subject to all the rigors of “pay or return by the midnight deadline.”
- b. The item is an “overdue item” originally payable on demand, but having been previously dishonored must, for midnight deadline purposes, be treated as an “other item” under section 4-302(b) where the penalty for missing the midnight deadline only applies if the item, when re-presented, is then “properly payable”.
- c. The item is being returned so that a demand on the drawer can be made for payment under the drawer’s contractual obligation and the drawee bank should be treated as a collecting bank subject only to the liability imposed on collecting banks by section 4-103(5).

Which of the three possible analyses should be taken? The solution will come from the “good news” method with careful consideration of the policy in favor of rapidly completing original collections without the burden of returning notification of payment in every case. Admittedly section 4-302 is an “enforcer” section. It imposes a severe penalty—“accountability”—in the cases to be covered by subsection (a) of section 4-302, namely, “whether properly payable or not.” Because the definition of “properly payable” in section 4-104(1)(i) includes “the availability of funds for payment at the time of decision to pay or dishonor,” “whether properly payable or not” imposes liability whether the drawer’s account had a sufficient balance, or whether the drawer’s signature was forged or the item was altered, or even if the drawer had no account at all. Since the section only applies “where an item is presented on and received by a payor bank,” the section has no application to an item drawn on another bank but included erroneously in a cash letter.⁵¹ This exception results from the definition of payor bank in section 4-105(b) as a bank “by which an item is payable as drawn or accepted.”

50. See text accompanying notes 37-42 *supra*.

51. See, e.g., *Citizens State Bank v. Martin*, 227 Kan. 580, 609 P.2d 670 (1980), holding that a bank to which an item was delivered due to an error in the pre-printed bank routing number was not any of the types of banks defined in UCC section 4-106, and hence was not under any duty except to return the item to the clearing house presenting it.

How far should the policy of strict liability for the payment of items "whether properly payable or not" extend? Strict liability for failure to observe the midnight deadline makes sense in that it protects those persons disbursing the amount of the provisional credit for a deposit of the item on time schedules based on the time normally consumed in the three steps of collection: transmission to a payor bank, processing at that bank, and transmission of notice of non-payment back to the depository institution. The risk of unexpected delay in the transmissions between banks is an assumable risk in view of the fact that over 99% of the items presented are paid.⁵² Equally the risk of missing the midnight deadline and incurring "accountability" is an assumable risk for the payor bank on these percentages.

Where, however, an item that has been previously dishonored, with due notice thereof given, is again presented, the risks and policies are quite different. The incidence of full payment runs, according to recent studies,⁵³ from 50% to 95%, averaging 72.5%. The forwarding bank has already received one notice of non-payment and cannot thereafter become a holder in due course.⁵⁴ Thus arguments based on a chain of credit created by forwarding the item lose much of their force. The item is tainted by notice of dishonor. Section 3-304(3) provides that a purchaser "has notice that an instrument is overdue if he has reason to know . . . (c) that he is taking a demand instrument after demand has been made." Holder in due course status is not obtained until value is given by a withdrawal, and notice comes in time if it comes before value is given. The time of "taking" referred to in Section 3-304(3)(c) is when withdrawal is permitted. Thus, the time of taking and the time of giving of value are the same—namely the time of withdrawal. Only provisional credit was given when the item was first deposited. The time of "taking" and withdrawal occurs after notice that a demand has been made is necessarily implied from the first return, at which time the instrument is already overdue. Section 3-304(3) is, however, couched in terms of taking after receipt of reason to know that the taking occurred after demand has been made. Thus, while depository bank is advancing against an overdue item if the advance (or withdrawal) is made after the cash letter containing the item in question reaches the payor bank (for that is the time when the demand for payment is made), it is subject to "reason to know"

52. Since the incidence of "returns" is felt to be higher for checks drawn by individuals than for those drawn by businesses or governments, it is significant that the figures available for "share drafts" drawn on credit unions (almost exclusively individual accounts) show, in recent months, that the percentage of items returned drawn on credit unions is very small. For example, in November 1981, the Chase Manhattan Bank returned 90,316 items drawn on credit unions out of some 13.5 million items—or about 0.66%. The figures for September and October are similar. ICU Services Corporation, *ICU Share Draft Program*, MONTHLY EVALUATION REP. (Madison, Wisc. 1981).

53. A study reporting these figures is discussed in *The Wall Street Journal*, Feb. 5, 1982, at 21, col. 4 (Sheshunoff & Co. study). Conversations with bankers also indicate a payment range for re-presented items of between 50% and 95%, averaging 72.5%.

54. Under UCC section 3-302, to be a holder in due course one must take without notice of maturity or prior dishonor.

only when the return-item marked NSF is received. Also, being a holder in due course confers no rights against a drawee, only rights against the drawer.⁵⁵

Again, the policy behind section 4-302 is that a notice of non-payment, i.e., notice of dishonor, should go out by the midnight deadline since notice of payment is never sent.⁵⁶ But should further notice be required subject to so severe a penalty when a previous notice has already been sent? Treating the second presentment as accompanied by another indorsement, we find under section 3-501(4) that neither presentment nor notice of dishonor nor protest is necessary to charge an indorser who has indorsed an instrument after maturity. A literal reading of section 4-301(3) also indicates that once a notice of dishonor has been sent, that dishonor stands and no further dishonor occurs.⁵⁷ Section 3-507(4) provides for a waiver of dishonor and a re-presentment up to the end of the time specified in a term in a draft allowing a stated time for re-presentment in the event of any dishonor,⁵⁸ but checks have no such term. Had it been considered that a re-presentment after an initial dishonor would still be subject to the same rules as the original presentment, is not the subsection mere surplusage? Also it should be noted that both the May 1949 and May 1950 drafts of what is now section 4-202(1)(b) specifically provided that when a collecting bank learned an item had not been paid, it could, "[i]f its transferor has so agreed, . . . have the item presented again prior to the giving of such notice" of dishonor.⁵⁹ There was no special comment on this sentence. It disappeared in subsequent drafts as did other relatively innovative ideas.

Finally, showing that once dishonored or overdue an item is to be treated differently, section 3-511(4) provides that a draft dishonored by non-acceptance need not be later presented for payment, and notice of dishonor and protest are excused unless in the meantime the instrument has been accepted, thereby removing it from the category of dishonored or overdue instruments.⁶⁰

55. But the "chain of credit" argument based on lack of receipt of notice of non-payment presumed that the disbursement of funds by the depository bank is made with an expectation of the added security afforded to a holder in due course, even if only against the drawer. The validity of the expectation may be subject to question.

56. The yearly saving effected by this procedure without notifying a depositor, assuming a one percent return item rate, 40 billion items, and a 75% collection rate, would be \$150,000,000 a year, using 20¢ for postage and 30¢ for the cost of notice forms and their preparation. But the saving does not justify putting a loss upon payor banks of the face amount of the items found to be still not properly payable on second presentment and not returned. Depository banks should obtain contracts extending the time to give notice of dishonor from all depositors. Unless they do so, even a timely return of a second presentment will be too late and the depositor's indorsement liability will have been discharged. So also, the first return can be held to be the "learning" that it will not receive payment in due course so as to foreclose the right of charge-back under UCC section 4-212.

57. The section reads: "*Unless previous notice of dishonor has been sent* an item is dishonored at the time when for purposes of dishonor it is returned or notice sent in accordance with this section." U.C.C. § 4-301 (1978) (emphasis added).

58. The practice of using such a term in drafts is far more prevalent in European civil law systems than in the United States. The provision was included in the Code as a step toward greater international uniformity. See Leary and Husted, *An Approach to Drafting an International Commercial Code and a Modus Operandi under Present Laws*, 49 COLUM. L. REV. 1070 (1949).

59. This is far from an automatic right of the collecting bank. A transferor's consent is required.

60. The section's ancestry stems from the original NIL section 137 that also related to acceptance but was by analogy applied to payment. This section was construed, pre-Code, as applying to checks presented for

Thus, from all of the foregoing, there is ample support for placing an item being presented again after a dishonor in a different category from the same item on its first presentment.⁶¹

The earliest case to discuss the issue of the re-presented check under the Code was *Leaderbrand v. Central State Bank of Wichita*.⁶² The Kansas Court there discussed not only section 3-511(4), but also sections 4-301(3) and 4-301(1). It then concluded, in a passage not frequently cited, "The appellant herein, once he had timely notice of dishonor upon presentment of the check for payment, was charged with knowledge that the validity of the instrument was impaired."⁶³ Subsequent cases have distinguished the *Leaderbrand* case as if it relied exclusively on section 3-511(4). But the court clearly was relying (and properly, we think) upon the entire mosaic of the Code's references to previously dishonored items, and to the fact that the reason for the stringent rule of section 4-302(a) did not apply to a re-presented check after a previous dishonor. *Leaderbrand* was followed by the Oklahoma Court of Appeals in *Goodman v. Norman Bank of Commerce*.⁶⁴ Neither court clearly stated that the result was to treat the re-presented item as an "other" item under section 4-302(b), but in the cases the same result is reached as there were not sufficient funds to pay in the account at any time between the second presentment and the ultimate return long after the midnight deadline had expired.

payment. See, e.g., *Wisner v. First Nat'l Bank of Gallitzin*, 220 Pa. 21, 68 A. 955 (1908), and its numerous progeny that ignore the almost simultaneous action of the Pennsylvania legislature in directing the opposite result. 1909 Pa. Laws 169. Continued citing of *Wisner* stems from the fact that Shepards Citator does not include legislative reversals of reported decisions. A decision of another jurisdiction should only be persuasive if it still represents the public policy of that jurisdiction, at least where a choice between conflicting precedents exists.

61. By considering all of the sections just discussed together and the underlying policy behind the severe penalty in section 4-302(a), the conclusion is reached that no reason of policy requires according the full panoply of section 4-302(a)'s protection to the re-presented item, even if forwarded in a cash letter. *A fortiori* the treatment of "other items" [section 4-302(b)] should be accorded to a second presentment if made as a collection item with request for specific remittance. Non-receipt of remittance is a clear indication that payment may not have been made.

62. 202 Kan. 450, 460, 450 P.2d 1,9 (1969). The two previous presentments were made by the holder in person. Thereafter plaintiff deposited the item in First State Bank in Salina, Kansas. He was advised he would not receive immediate credit. First State did not use the cash item channel "but sent the check directly to the Central State Bank 'mailed for collection.'" It was received no later than March 22, 1966 and was returned unpaid on April 5, 1966, fourteen days later, when the drawer stopped payment and returned the goods in payment for which the check had been issued. The drawer's account was continuously without funds. Note that since the goods had been returned, recovery would have unjustly enriched the seller.

63. *Id.*

64. 551 P.2d 661 (Okla. App. 1976). The check was first sent through the Federal Reserve Bank as a cash item. It was deposited November 1, 1973 and, curiously, not presented until November 6, 1973. It was dishonored and returned properly on November 7, 1973. Later on November 14, 1973, it was presented again through a correspondent bank as a cash item, but not returned again dishonored until November 19, 1973, five days later. Significantly, the *Norman* court quoted the following passage, among others, from *Leaderbrand*:

The sanction imposed by the provisions of section 84-4-302, supra, were designed to compel compliance with the statutory duties imposed upon the payor bank, but once those duties have been discharged by the payor bank the statutory scheme which emphasizes the importance of speed in the collection process, and the prompt settlement of such items because of the chain of credit dependent thereon has been fulfilled, and the reason for the sanction imposed disappears. It was not the intention of the legislature to arbitrarily impose [sic] liability upon the payor bank under [sic] the facts and circumstances here confronting the court.

551 P.2d 661 (Okla. App. 1976) (quoting 202 Kan. 450, 460, 450 P.2d 1, 9 (1969). Thus these courts clearly apply the "good news" method and do not place the decision solely on section 3-511(4).

The New York Court of Appeals in *David Graubart, Inc. v. Bank Leumi Trust Co.*⁶⁵ construed *Leaderbrand* as relying solely on the section 3-511(4) analogy. It need not have done so, as it decided the case in favor of the payor bank on the ground that the payee, by re-depositing "for collection" with no provisional credit given, became subject to a banking custom "whereunder previously dishonored checks were to be held for such time as is reasonable under all the circumstances, even beyond the midnight deadline if necessary, to enable funds from which to pay them to come into the account."⁶⁶ The court relied on section 4-201's use of an agency relationship arising upon a deposit to rule that the payee was bound by the custom of sending re-presented checks through the collection channel (non-cash items), not the cash item channel, especially since the payee had received an "advice to customer" slip indicating the special handling. The court felt that holding for seven days under the custom met the tests of reasonableness even though the collection letter bore a printed legend, "Special Instruction: (Return immediately if not paid unless otherwise instructed)," since this was followed by a typed direction that the payor bank was to "remit (its) cashiers' [sic] check when paid."⁶⁷

One might, however, gently chide the court for inconsistency in its opinion. After rejecting *Leaderbrand's* essentially "no longer a demand item" approach, by indicating that it depended entirely on an interpretation of section 3-511(4) which really applied only to time items, the court then said:

In contrast a demand item such as a check may eventually be paid off if resubmitted at a time when the drawer's account has an adequate balance. This possibility makes it entirely reasonable to afford redeposited checks the full panoply of article 4 protections (See, generally, Clark and Squillante, *Law of Bank Deposits, Collections and Credit Cards* [1970], pp 71-72).⁶⁸

65. 48 N.Y.2d 554, 399 N.E.2d 930, 423 N.Y.S.2d 899 (1979). Prior to *Graubart*, the re-presentment issues had surfaced, or were thought to have surfaced, in *Blake v. Woodford Bank & Trust Co.*, 555 S.W.2d 589 (Ky. App. 1977); *Sun River Cattle Co. v. Miners Bank of Montana N.A.*, 164 Mont. 237, 521 P.2d 679 (1974); *Wiley v. Peoples Bank & Trust Co.*, 438 F.2d 513 (5th Cir. 1971). There was also the peculiar case of *United States v. Loskocinski*, 403 F. Supp. 75 (E.D.N.Y. 1975), involving a grand jury subpoena for checks not yet returned. Actually, only *Blake* and *Sun River*, both involving a second presentment as still a cash item, involved the issue we here discuss. *Wiley* involved envelope drafts held to be documentary drafts under section 4-302(b). A second decision by the court held the bank liable for the face amount of the items on an amended complaint raising non-compliance with sections 4-501 to 4-504 and a common law issue of negligence. An examination of the briefs of counsel and the lower court opinion discloses that while the account was active, due to set-offs by the bank, the balances never reached the level necessary to pay the items in the case being held for payment. See *Wiley v. Peoples Bank & Trust Co.*, 11 U.C.C. Rep. Serv. (Callaghan) 154 (N.D. Miss. 1971), *aff'd on same grounds*, 462 F.2d 179 (5th Cir. 1972). The court applied section 4-302(b) without any discussion of the definition of "properly payable." In both *Sun River* and *Wiley* the decision could have been influenced by the bank's exercise of set-off against incoming funds. *Loskocinski* concerned whether items subpoenaed for the grand jury were excused from being physically returned. The prosecutor was ordered, in effect, to use photostats.

66. *David Graubart, Inc. v. Bank Leumi Trust Co.*, 48 N.Y.2d 554, 558, 399 N.E.2d 930, 932, 423 N.Y.S.2d 899, 902 (1979).

67. On any "chain of credit" analysis, the instruction to "remit when paid" by cashier's check indicated that payment would not be presumed from an absence of any reply. A cashier's check was expected.

68. *David Graubart, Inc. v. Bank Leumi Trust Co.*, 48 N.Y.2d 554, 560, 399 N.E.2d 930, 933, 423 N.Y.S.2d 899, 903 (1979) (emphasis supplied). However, when discussing the non-cash item channel in the light of the banking custom the court also said of the procedure:

It creates no provisional credits that must be firmed up, and the payee can only collect when the payor

This would indicate liability even if the account did *not* have an adequate balance.

But when discussing the reasonableness of custom stated in the payor bank's summary judgment affidavits, without a contrary factual affidavit from the plaintiff, the court said, "The reasonableness of such a banking custom must, therefore, be measured on its own terms. We conclude that this criterion is met when a depository bank takes a *possibly worthless* instrument and directs the payor bank to adopt a technique that may provide the only chance for collection."⁶⁹ Here a footnote pointed out that the payee pointed to no facts indicating that holding the check for seven days was holding for an unreasonable time. The court continued:

There is nothing unfair about this procedure. It is calculated to produce satisfied obligations in many instances where legal recourse, with all its attendant expense, inconvenience and uncertainty, would otherwise be necessary. Furthermore, the payee here cannot claim it was injured by its reliance on the bank's silence after receipt of the item; the prior dishonor provided adequate warning of the questionable safety of the instrument.⁷⁰

Does it make good sense to construe the Code as imposing liability on a bank processing a previously dishonored item because there is a "possibility" that on re-presentment funds may come into the account when they in fact have not and the payee has been provided adequate warning of a "possibly worthless instrument" by the prior dishonor? Does not such a construction ignore the underlying policy to be implemented by section 4-302(a) by its implication that, absent proof of a custom, the item even in the collection channel subjects the payor bank to a withdrawal of stockholders equity when funds to pay have not come in? Would not a classification of the overdue and dishonored check as an "other item," thereby triggering the operation of section 4-302(b), reach a proper result? Such an approach makes the midnight deadline and accountability applicable when, in fact, the "possibility" of a deposit of sufficient funds has become a fact, but would permit a holding for a further reasonable time in order to secure payment where the "possibility" has not eventuated and the item is still "possibly worthless."

Construction of a "dishonored" item as being no longer a "demand" item is consistent with the spirit of the statute and will reach the result reached by the New York Court of Appeals in *Graubart* without subjecting banks

bank remits the cashier's check, thus signifying that the drawer's account received sufficient funds to cover the check. By its nature, the procedure singles out the item as an exceptional one; no transferor will assume it has been paid until specific notice is received.

Id. at 563, 399 N.E.2d at 935, 423 N.Y.S.2d at 905. But should a result of strict liability depend on the sender's method of sending or on the payor bank's method of handling on receipt, subject to liability for any lack of collectibility caused by the delay in the return? Very recently the California Superior Court also held that a complaint by a depositor alleging a second presentment after a return N.S.F. and a failure to observe the midnight deadline stated a cause of action against the payor bank. *Huntmix, Inc. v. Bank of America N.T. & S.A.*, 2D Civ. No. 64296, Superior Ct. No. C-333853. A petition for review by the California Supreme Court was denied in September 1982.

69. *Id.*, 399 N.E.2d at 935-36, 423 N.Y.S.2d at 905 (emphasis supplied).

70. *Id.*, 399 N.E.2d at 936, 423 N.Y.S.2d at 905.

to the risky business of proving a banking custom in litigation, with consequent attack on its reasonableness. Nor, as the Code is now drafted, would there be the necessity of treating re-presented items individually, and at greater expense, as collection items to trigger the custom. The previous dishonor prevents a depository bank from thereafter becoming a holder in due course. Hence, any withdrawal of funds or provisional credit after receipt of the first return is purely on the credit of its depositor. Both depositor and depository bank are, or should be, aware of the substantially increased risk of non-payment ranging from 5,000% to 500% with an average of 2,500%. In view of the increase in risk, a depository bank re-presenting a check through the cash item system of provisional credits can be said to be voluntarily assuming the risk of uncollectability from its customer. Indeed, if the depository bank re-presents without notifying its customer it may run the risk of losing all indorsers' contractual liability even though it would retain any warranty liability if, for example, the return was because of an alteration or forged prior indorsement.⁷¹

In any event, it is suggested that the discussion in the cases about whether dishonor for non-acceptance includes non-payment is beside the point. The true issue is whether the dishonored item is still a demand item for the purposes of section 4-302(a) or whether it has become a dishonored item and hence an "other item" for purposes of section 4-302(b). If the latter, liability is imposed only if the item was, when re-presented, in fact "properly payable," including the availability of funds in the account during the midnight deadline period after re-presentation.

None of the three ways of treating the re-presentation item mentioned above are totally satisfactory. This is especially true for the third, which treats it as if it were a draft on the drawer sent for collection from the drawer under the drawer's contractual promise to pay if the drawee does not. Yet that is often the way the banks treat an item presented for the second time, at least when it is still NSF and continues to be so during the holding period.

The difficulty may, in part, flow from the failure of the Code and courts facing a re-presentation problem to distinguish between items in the cash and non-cash collection channels next to be discussed in this connection.

One of the discoveries made by the senior author in the attempt to overcome the ignorance of the subject, which caused him to be selected as a member of the drafting staff, was that the practical banker appeared to be somewhat more concerned with the *manner* in which an item is sent for collection rather than the *nature* of the item. In the late 1940s, there were two distinct Federal Reserve Regulations involved: Regulation G covering non-cash items, and Regulation J covering cash items, as defined in those regulations. The regulations have now been combined in the present Regulation J, but the terms cash and non-cash remain.⁷²

71. An indorser is fully discharged by a failure to give notice of dishonor. U.C.C. § 3-501(2)(a).

72. Regulation J, 12 C.F.R. 210.1 (1981).

The "pay now and investigate at leisure" policy used in the cash item channel was customarily not used in the collection item channel. In the collection channel the final bank in the chain would remit by a draft drawn on another bank or, often, by its own cashier's check, and even provisional credit might not be given until a remittance was received.⁷³ Conceivably a court could look at the sending channel used for second presentment and find some estoppel as a basis to assert the non-applicability of the "whether properly payable or not" penalty of section 4-302(a) when the collection item channel was used.

What then is the "enforcer" section for the "other item" that is not properly payable, including the check on its post-dishonor presentment?

There is no section in Article 4 which specifically addresses the problem of liability for an "other" item that is not properly payable. It would seem that section 3-419(1)(b) on conversion of instrument arguably is applicable. Taken together with the measure of liability placed on a drawee under section 3-419(2), the effect is more drastic than the accountability imposed by section 4-302 or 4-213. The effect is liability for the face amount of the instrument in conversion. The liability is said to be absolute. The key words, however, are "refuse on demand either to pay or to return." The comment is helpful. While it does point out that the demand for return may be made at the time of delivery, the demand referred to is for a "return at a particular time" indicating the need for some specificity of time. Also the comment distinguishes between a failure to return and the required "refusal" to return. The comment states:

"Refuses" is meant to cover any intentional failure to return the instrument including its intentional destruction. It does not cover a negligent loss or destruction, or any other unintentional failure to return. In such a case the party may be liable in tort for any damages sustained as a result of his negligence, but he is not liable as a converter under this section.⁷⁴

The distinction must not be one between "negligence" and any "intentional" failure to return. The action is in conversion and should require a deliberate exercise of dominion over the instrument in a manner inconsistent with the possessory and ownership rights of the original depositor. The failure to return must constitute a violation of the general duty of "good faith" that runs throughout the Code.⁷⁵

Thus in *Wiley v. Peoples Bank and Trust*⁷⁶ and in *Sun River Cattle Co. v. Miner's Bank of Montana N.A.*⁷⁷ the courts' decisions in respect of the re-

73. Professor Gerald R. Dunne, then Vice President and Counsel to the Federal Reserve Bank of St. Louis, questioned the wisdom of the omission of provisions governing the non-cash item channel at the Advanced ALI-ABA Course of Study on Banking & Secured Transactions under the Uniform Commercial Code held at New Orleans, February 1-4, 1967. See 1968 ADVANCED ALI-ABA COURSE IN BANKING AND SECURED TRANSACTIONS 38-39.

74. U.C.C. § 3-419, comment 2 (1978).

75. See U.C.C. § 1-203 (1978).

76. 438 F.2d 513 (5th Cir. 1971).

77. 164 Mont. 237, 521 P.2d 679 (1974). Another case considering the problem is *Bank Leumi Trust Co. of N.Y. v. Bank of Mid-Jersey*, 499 F. Supp. 1022 (D.N.J. 1980). The winner in *Graubart* (see note 65 *supra*) sued

presented items there involved should have been bottomed on a concept of conversion. In these cases the re-presented items were held beyond the midnight deadline, but the banks involved, by a continuous exercise of set-offs, prevented deposits from accumulating sufficient funds to pay the pending items. Only an owner of the items should be able to make such a choice. But the courts, in imposing the penalty of accountability on the banks, seemingly ignored section 4-303(2) which, by permitting banks to charge items to an account "in any order convenient to the bank" appears to permit set-offs to take precedence over items held to be covered by incoming deposits. This is apparently so because under section 4-303(1) the exercise of the set-off comes too late only if it is exercised after the bank has completed the process of posting or become accountable for the amount of the item.

A rationale supporting the decisions could be that in holding "other" items not properly payable after the midnight deadline, the bank has transformed its status from that of a payor bank to that of a quasi-fiduciary to collect from incoming deposits for the benefit of the true owner.⁷⁸ If, instead, the bank first exercises its own right of set-off it has exercised dominion over the items it is holding and has converted them. But such an analysis does not require either the imposition of conversion liability on a payor bank merely holding "other items" beyond the midnight deadline where new deposits did not come in and the items remained not properly payable throughout the holding period, nor does it require a previously dishonored clean demand item to impose accountability on second presentment if it is treated by the payor bank as an "other item."

The "good news" solution is that, on second presentment, the underlying purposes and policies of the Code in the field of bank collections are best promoted by classifying the item as an "other item" and by applying conversion liability where the intentional failure to return on demand is found to have been taken in connection with the exercise of set-offs to pay the bank's own debt preferentially.

C. *The 3-419(3) Defense*

This subsection follows the two subsections on conversion just discussed and also needs consideration under the "good news" approach. White and Summers have characterized the judicial treatment of this subsection as treatment that should not happen to a dog.⁷⁹ The treatment, we suggest,

Mid-Jersey for a late return on a second presentment, as to which Bank Leumi failed to observe the "custom" it so successfully presented to the court in *Graubart*. Further, it carelessly misencoded the item on second sending, adding 72 cents, thereby causing Mid-Jersey's computer to overlook a stop order. The "good news" mosaic was not presented to the court, only a section 4-108 defense based on misencoding, a section 3-511(4) defense considered alone, and a claim that acceptance by the Federal Reserve Bank of the late return was an "agreement otherwise." All such defenses were rejected.

78. Indeed there is some language in pre-Code cases describing a payor bank receiving direct sendings as "an agent to present to itself." See, e.g., *Exchange Bank of Wheeling v. Sutton Bank*, 78 Md. 577, 28 A. 563 (1894); *Florida Citrus Exch. v. Union Trust Co.*, 244 A.D. 68, 278 N.Y.S. 313 (4th Dept. 1935).

79. J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* 591 (2d Ed. 1980).

results from a failure to consider the interrelation of the scheme of Article 4 with the thrust and purpose of the subsection.

In essence, the defense is the "innocent commercial agent" defense found in several articles.⁸⁰ With regard to the handling of securities, the defense is found in section 8-318, covering an agent or bailee receiving securities in good faith and selling, pledging, or delivering them according to the instructions of his principal where the principal is acting wrongfully. The defense is against liability in conversion or for participation in breach of fiduciary duty. The required good faith includes the "observance of reasonable commercial standards if he is in the business of buying, selling or otherwise dealing with securities."⁸¹

Similarly, in Article 7 on Documents of Title, section 7-404, descended from section 10 of the Uniform Warehouse Receipts Act, and section 13 of the Uniform Bills of Lading Act, the "innocent agent" doctrine is kept applicable to commercial carriers and warehousemen. The requirements of good faith, the observance of reasonable commercial standards, and compliance with the terms of the document of title involved apply. It matters not that the person from whom the bailee received the goods and the person to whom they were delivered had no rights in the goods.

The innocent agent rule appeared in the May 1949 drafts on documents of title and commercial paper. There was no similar provision in the May 1949 draft of Article 8 on Investment Securities. The provisions of Article 3 in the same draft were contained in sections 3-426 and 3-427. Subsection (2) of the former section on conversion of an instrument provided the same rule of damages for all conversions. The obligation of a signer was only presumed to be worth the face value of the instrument. Section 3-427 of the draft was captioned "Innocent Conversion, by Representative" and related only to "a representative" dealing in good faith. Of course, in these early drafts the definition of good faith in Section 1-201 included "the observance by a person

80. The need to expand the "innocent agent" defense, see U.C.C. § 3-419(3), comment 5 (1978), to expedite the handling of items may have been one of the bases for the original suggestion for an Article on Commercial Agency in the Code. See text accompanying note 4 *supra*. The rather general statements in the literature that the "innocent agent" rule applied only to brokers selling investment securities is not correct. For example, in *National Park Bank of New York v. Seaboard Bank*, 114 N.Y. 28, 33-34, 20 N.E. 632, 633 (1889), Vann, J., said, in a case by a payor bank against a depository bank involving a raised check,

If the defendant had then owned the draft it would have become liable, upon discovery of the facts, to refund the amount mispaid, provided its condition had not in the meantime changed so that this would be unjust. *Bank v. Banking Ass'n*, 55 N.Y. 211, *White v. Continental Nat'l Bank*, 64 N.Y. 316. If, however, the defendant did not then own the draft, but merely presented it for payment as the agent of another bank, it could not be required to repay, provided it had paid over to its principal before notice of the mistake. *La Farge v. Kneeland*, 7 Cow. 460, *Mowatt v. McLelan*, 1 Wend. 173; *Herrick v. Gallagher*, 60 Barb. 566, Story on Agency, § 300.

The Court of Appeals affirmed the trial court's judgment for the defendant. See also the discussion of the innocent agent rule in *Canal Bank v. Bank of Albany*, 1 Hill 287 (N.Y. Sup. Ct. 1841), pointing out that the agency must be known to the payor seeking recovery. Professor Llewellyn's point was that where the bank collection statute made every depository and collecting bank an agent, the agency always would be known and the policy preventing recovery in an action by a payor bank for money had and received should also apply in a payee's suit for conversion or for money had and received. Hence it was agreed that what is now section 3-419(3) should have a broad application, except in warranty suits.

81. U.C.C. § 8-318 (1978).

of the reasonable commercial standards of any business or trade in which he is engaged."

For the 1950 draft the two sections were combined as section 3-419 with but three substantive changes. First was the insertion of "including a depository bank" following the word "representative." The senior author has a distinct recollection as to the making of that change. It was made when Professors Llewellyn and Mentschikoff, then married, were at Harvard Law School. They, with the senior author were in the kitchen of the house rented by the Llewellyns. At breakfast there was a discussion of the innocent agent rule. Karl Llewellyn expounded on the rule stating that it was a basic rule designed to speed up commercial transactions and should be included throughout the Code. He stated that commercial agents should not be subject to duties of investigation of the title and right to act of those with whom they dealt in good faith, as he felt the burden on the many, many good transactions would be too heavy. He reasoned that any investigation would necessarily have to go beyond the principal dealing with the agent and so would place an unnecessary burden on transactions inconsistent with the fact that the principal was the apparent holder of a negotiable instrument, security, or document of title.

The use of the words "dealt with" indicated that when claim was made by the true owner the "innocent agent" had parted with the instrument. It therefore follows that while the instrument is in the hands of the agent, its return to the true owner can be compelled.

The second substantive change was the addition of the words "beyond the amount of any proceeds remaining in his hands," although this was really out of an abundance of caution.

The final change was the insertion of the words "or otherwise" following the word "conversion." As stated above, in Article 8, when the provisions of the innocent agent rule were written therein, the word "conversion" was followed by "or for participation in breach of fiduciary duty." In the case of the collection of drafts and notes, this exposure was present, but more familiar to those working in the field than breach of a fiduciary duty was the equitable action for "money had and received" or "money paid under mistake."

Today, everyone is so familiar with the Code's "presentment warranties" in sections 3-417(1) and 4-207(1) that we tend to forget that prior to the Code there were no warranties running to a payor bank or otherwise to a payor. The customary indorsement "pay any bank, banker or trust company, all prior endorsements guaranteed" was the bankers' solution to the problem that a payor bank's action to recover a payment made on a forged indorsement was only in the nature of an action for money had and received, in which a collecting bank could defend on the ground that it, as a good faith collecting agent, had remitted the funds to its transferor. Out of an abundance of caution, the May 1949 draft on bank collections contained language providing for the continuance of warranty liability notwithstanding that payment or credit had, prior to the claim for refund, been remitted to its transferor. This was felt

necessary despite the fact that the liability imposed by section 3-419 was to the true owner and the new warranty liability was to the payor.

When the Code was being drafted there was more force to privity of contract than remains today. It is, therefore, fair to state that the Code scheme as to, for example, liability for acting on forged indorsements was to place liability to the drawer or payee on the payor bank, and to place that bank's right to recover the payment squarely on warranty liability. The one exception, of course, relates to the unusual case of a payee claiming against a depository or intermediary bank at a time when either the instrument or its proceeds are still under the control of that bank.⁸²

In view of what some courts have since done to the scheme through actions ruled not to be taken in the character of representatives⁸³ or not to constitute the observance of reasonable commercial standards,⁸⁴ as well as giving a drawer standing to sue on the payment warranties,⁸⁵ is this a case where the bad news prevails over the good news? What policies were to be furthered by the Code scheme? Are these policies viable policies today?

To see if there is a "good news" answer to these questions, we must consider two scenarios. The first is where the wrongful intrusion into the payment process occurs in the item issuing process of the drawer. This is where the drawer might be liable because the indorsement is effective under any one of the subdivisions of section 3-405, or where the drawer is precluded under sections 3-406, 3-404, or 4-406. This scenario was uppermost in the minds of the drafters. These were the areas of considerable litigation. In such a scenario, the payor bank, based on its dealings with the drawer, was in a better position to know of and to develop the facts supporting the allocation to the drawer of such forgery and alteration losses.

Does such a procedure provide for a multiplicity of actions or circuity of action? We believe that this result need not, and very often does not, follow. We have not found the point being made in opinions rendered in cases involving a payor bank. This is because when suit is necessary and is brought against a payor bank, that bank usually "vouches in" the depository bank or banks involved.⁸⁶ Often they appear and give aid and comfort to the payor

82. The payee's cause of action in conversion or for money held for plaintiff's use is not clearly stated in section 3-419(1), as it uses the term "paid" whereas the action, in reality, when brought against a depository bank, is for collection and wrongful disbursement.

83. See, e.g., *Cooper v. Union Bank*, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1, (1973); *Ervin v. Dauphin Deposit Trust Co.*, 38 Pa. D. & C.2d 473, 3 U.C.C. Rep. Serv. (Callaghan) 313 (Pa. C.P. 1965).

84. For an extraordinary case, see *Tormo v. Yormack*, 17 U.C.C. Rep. Serv. (Callaghan). 166 (D.N.J. 1975), apparently requiring a separate handling of the accounts of indicted customers after the bank learns of the indictment.

85. See, e.g., *Sun 'N Sand, Inc. v. United Cal. Bank*, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978).

86. See U.C.C. § 3-303 (1978). Where the suit is against the depository bank by drawer or payee, there is no basis for making the payor bank a party. See *Clarkson v. Selected Risks Ins. Co.*, 170 N.J. Super. 373, 406 A.2d 494 (1979), for an excellent example of the resolution of the claims of several parties who are unfortunate enough to have handled a jointly payable check containing a forged indorsement. Query whether or not a direct suit would have reduced that court's "procedural gymnastics" intended to rest liability where a direct drawer versus depository suit would directly place it—on the first solvent party within the court's jurisdiction to directly deal with the forger, unless a ratification or preclusion exists.

bank's defense of the case. We conclude, therefore, that where the drawer is the plaintiff there should be no direct action against a depositary bank. We agree with the analysis of the *Stone & Webster* case⁸⁷ in Massachusetts. The suggestion that the depositary bank be allowed to assert any preclusion of the suit that the drawee bank, if sued, could have asserted comes as a compromise. But, without prolonging the case by excessive discovery, would not the preclusions be more efficiently litigated by the payor bank?

With deference and respect we suggest that the California court's extension of the reach of the presentment warranties on a third party beneficiary theory⁸⁸ or the more recent "other payor" theory⁸⁹ do not follow the Code spirit. The same is true for the cases following those decisions in other jurisdictions.⁹⁰ True, the dogma states that when sued the depositary bank may set up any defense that could have been asserted by the payor bank against a suit by the drawer. But as stated above this is not an efficient method. It has two faults. First, the depositary bank's lack of knowledge of the drawer's operations could lead to extensive pleading and pre-trial depositions on every known defense. Second, the direct suit avoids several pressures on the parties to make out-of-court settlements. These pressures not only arise between a drawer and its bank, but also between banks, especially if the bankers' blanket bond of each has been written by the same insurer or allied insurers.

We also suggest that the New York Court of Appeals may have nodded in the *Underpinning* case⁹¹ where a drawer was allowed to sue a depositary bank for disregarding a restrictive indorsement. The indorsement was effective against the drawer because the payee's name was supplied by an "agent or employee" of the drawer. Yet the court may have been correct. Section 3-419(3) does indicate that the policy favoring enforcement of restrictive indorsements is stronger than the policy underlying the section 3-419(3) defense. But we suggest that the insertion of the reference to restrictive indorsements in the 1956 revisions contemplated a conversion action brought by a restrictive indorser, not a person against whom the indorsement was effective. In the *Underpinning* case there was no section 3-419(3) defense as the action was not in conversion. The payee was fictitious in the sense that the crook supplied the name and amount on a false invoice, intending, at the time it was so supplied, that the named payee have no interest in the check. The

87. *Stone & Webster Eng'g Corp. v. First Nat'l Bank & Trust Co. of Greenfield*, 345 Mass. 1, 184 N.E.2d 358 (1962). See also *Western Union Tel. Co. v. Peoples Nat'l Bank in Lakewood*, 169 N.J. Super. 272, 404 A.2d 1178 (1980), citing *Stone & Webster* and *Life Ins. Co. of Va. v. Snyder*, 141 N.J. Super. 539, 358 A.2d 859 (1976), and concluding that a direct drawer v. depositary suit should be disallowed since such a suit may permit recovery in certain factual situations where, if the drawer were forced to sue the drawee directly, the action would be barred by some defense between the two (UCC sections 3-406, 3-405, 4-406) and "those issues should be decided first." 169 N.J. Super. 272, 278, 404 A.2d 1178, 1181.

88. *Allied Concord Fin. Corp. v. Bank of America*, 275 Cal. App. 2d 1, 80 Cal. Rptr. 622 (1969).

89. See, e.g., *Sun 'N Sand, Inc. v. United Cal. Bank*, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978).

90. See, e.g., *Insurance Co. of N. America v. Atlas Supply Co.*, 121 Ga. App. 1, 172 S.E.2d 632 (1970).

91. *Underpinning & Found. Constructors, Inc. v. Chase Manhattan Bank*, 46 N.Y.2d 459, 386 N.E.2d 1319, 414 N.Y.S.2d 298 (1979).

case was thus a section 3-405(1) case, which by its terms does not require even observance of reasonable commercial standards. What the court has done is to turn what the Code allocated as an employee's fidelity bond risk into a bankers' blanket bond risk because the crooked employee stupidly placed in the payee's indorsement the "for deposit" language used by the real payee in its rubber stamp indorsement on checks received.

Equally departing from Code policy are the cases where the courts hold that a depository bank, taking for deposit a check payable to a corporation and apparently indorsed by it to a third party, is on notice of potential defects in the third party's title.⁹² There is a neglected threshold issue. Is the indorsement effective? Section 3-405(1) uses the word "effective" without qualification. By using the chain of title as a device for placing a depository bank on notice of a defective title in its depositor, courts are almost completely undermining the "effectiveness" of the indorsement.⁹³ The same protection given the "market" of a holder in due course under the "shelter principle" of section 3-201(1) should apply to support the policy of section 3-405(1) that forgery occurring in the internal processes of check issuance is a drawer's responsibility and not a subsequent handler's responsibility. Placing liability on the latter will increase costs for all users of the checking system by over-protecting corporate check issuers through reducing the Code's built-in incentives to police corporate employees, since most suppliers to corporate drawers are themselves corporations.

The foregoing discussion is relevant to the section 3-419(3) defense because the cases discussed are grounds for holdings that the section 3-419(3) defense is not available as the depository bank involved did not act "in accordance with the reasonable commercial standards applicable to the business of" banking. To us, it seems as if the courts do not consider the impact on the ease and speed of commercial transactions of the preventive measures necessary to avoid a ruling that the bank failed to observe "reasonable commercial standards."⁹⁴ The personnel increase needed to accomplish the inspections

92. *Cairo Coop. Exch. v. First Nat'l Bank of Cunningham*, 228 Kan. 613, 620 P.2d 805 (1980); *Kraftsman Container Corp. v. United Counties Trust Co.*, 169 N.J. Super. 488, 404 A.2d 1288 (1979); *Underpinning & Found. Constructors, Inc. v. Chase Manhattan Bank*, 46 N.Y.2d 459, 386 N.E.2d 1319, 414 N.Y.S.2d 298 (1979); *C.S. Bowen Co. v. Maryland Nat'l Bank*, 36 Md. App. 26, 373 A.2d 30 (1977).

93. With regard to a depository bank's duty to comply with a minimum standard of care when dealing with an item wherein the circumstances surrounding its "negotiation" work to make the unauthorized indorsement effective, see the controversy in New Jersey. In *Kraftsman Container Corp. v. United Counties Trust Co.*, 169 N.J. Super. 488, 404 A.2d 1288 (1979), the court looked to sections 1-203, 1-202(3), 4-103(1), 4-401(2), and 1-201(19) and concluded that the good faith requirements which apply to all code sections do not permit a depository bank to handle a "3-405 item" with impunity. However, one year later this holding was limited in its scope by *Brighton, Inc. v. Colonial First Nat'l Bank*, 176 N.J. Super. 101, 422 A.2d 433 (1980), *aff'd*, 430 A.2d 902 (N.J. 1981), wherein *Kraftsman* was not controlling since there the drawer's action against the drawee was couched in non-UCC breach of contract terminology whereas the plaintiff in *Brighton* sued under the Code. Thus, since the suit was brought under the Code the court was forced to apply 3-405 as written without a corresponding duty resting on the party assisting the defense. However, note the strong dissent by Justice Handler on appeal to the Supreme Court, who argues that the defense of 3-405 cannot and should not be asserted if the actions of the party so asserting amount to *commercial recklessness*.

94. Some courts do attempt to evaluate such "commercial practicalities." See, e.g., *Cooper v. Union Bank*, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973). However, the position of the authors of this Article is that the great majority of the opinions which rule on this point fail to expressly consider such practicalities.

and verifications suggested would be quite large when applied to all items being deposited and handled through the banking system, for the procedures would necessarily apply to all deposited items.⁹⁵ Instead of just checking for the customer's indorsement—the last indorsement—the entire chain of indorsements would require inspection. We doubt that bank customers are yet ready for the simple solution, namely, that checks should not pass by indorsement but should only be deposited to the deposit account of the payee. This now, in fact, occurs when payment is made by an electronic credit transfer, either by standing order or by a telephone or ATM bill payment procedure, or by a wire transfer through Fed Wire, Bank Wire, "Chips," "Swift," or an A.C.H.

D. *Intrusion at the Payee Processing Stage.*

Before concluding, we should discuss one area where the "bad news" may be stronger than the "good news." We have just discussed the need to apply the Code's risk allocation policy in the interpretation of "reasonable commercial standards" under the section 3-419(3) defense where the wrongful intrusion occurs in the process of check issuance. What if the wrongful intrusion occurs during the payee processing stage? The Code recognizes issuance as a process involving more than one participant and allocates the risk of employee forgery to the employer to provide the necessary economic incentive for a proper policing of the process. It should not be interpreted as creating a rule of comparative negligence in that area. Unfortunately, the payee processing stage was not studied with equal care, and a risk allocation policy was not clearly adopted.

Instead, when faced with forgeries by payee employees, the only direct statutory weapon available is section 3-406 on negligence contributing to alteration or forgery. The drafting of section 3-406, as the comment shows, was almost entirely concerned with drawer or maker negligence. It clearly adopts the "blanks and spaces" rule of *Young v. Grote*.⁹⁶ Even in the discussion of the application of the section to "unauthorized" signatures in the comment, reference is made almost entirely to drawer action.⁹⁷ First, there is mention of negligent care of a signature stamp "or other automatic signature device." Then, the final specific is drawer negligence in mailing a check to a person of the same name as the payee who was not entitled to it. Between the two specifics is one sentence of comment stating, "The section extends, however, to cases where *the party* has notice that forgeries of his (sic) signature have occurred and is negligent in failing to prevent further forgeries by the same

95. For example, in joint payee cases courts have indicated that when a check is presented by one joint payee, a depository bank should check with the other joint payee to determine if the signature was genuine. *See, e.g., United Bank of Ariz. v. Mesa N.O. Nelson Co.*, 121 Ariz. 438, 590 P.2d 1384 (1979); *Belmar Trucking Corp. v. American Trust Co.*, 65 Misc. 2d 31, 8 U.C.C. Rep. Serv. (Callaghan) 73 (N.Y. Civ. Ct. 1970); *First Nat'l Bank of Louisville v. Progressive Casualty Ins. Co.*, 517 S.W.2d 226 (Ky. Ct. App. 1974).

96. 130 Eng. Rep. 764, 4 Bing. 253 (1827).

97. U.C.C. § 3-406, comment 7 (1978).

person.”⁹⁸ This, in view of section 4-406 applying only to a drawer, is an interesting sentence. Sandwiched between two references to drawer negligence it would seem to have only drawer application, leaving the courts free to fashion remedies for wrongful intrusions into the payment process by employees of the payee by applying, by analogy, the risk allocation devices used by the Code for internal intrusions in the process of check issuance, rather than relying on a negligence theory.

The analogy, broadly, is to apply a vicarious liability to employers for internal intrusion by employees.⁹⁹ The trouble is that in the case of drawers' employees, the intrusion results in the creation of a new instrument. In the case of intrusion by employees of the payee, the result is a diversion of an instrument from its intended route. In the case of a drawer's employees, the drawer's funds are diverted to the benefit of a faithless employee of the drawer. Initially, in the case of the payee's employees the result appears to be different. A diversion is seen as a diversion of the drawer's funds to the benefit of a faithless employee of the payee, quite a different situation.

But a further examination of the Code's scheme would indicate that the initial appearance is not the true situation. The payee's employees involved are those entrusted by the payee with the responsible handling of incoming instruments and their processing through the necessary bookkeeping procedures to ultimate deposit to the payee's account in a depository institution of the payee's own choosing. Thus the incoming item is received in an authorized manner. Under section 3-802(1)(b), the drawer's obligation to the payee on the underlying obligation is suspended pending presentment of the check.¹⁰⁰ If the indorsement in the name of the payee is held to be effective against the payee, then the drawer will be discharged, not only on the instrument, but on the underlying obligation.¹⁰¹ Thus the employee of the payee will have, in effect, diverted funds of the payee to the benefit of that employee or his or her confederates.

There remains a substantial difference between the situation of the drawer and of the payee. In the cases envisioned by section 3-405(1) there is a genuine signature of the drawer who has been hoodwinked by the faithless employee. But in both cases there is an unauthorized signature of a named payee on the item. Yet, in the case of the diversion of the check by employees of the payee, the unauthorized signature is that of their employer, who has been defrauded, not deceived into signing an indorsement. Is the difference

98. *Id.*

99. See Whaley, *Negligence and Negotiable Instruments*, 53 N.C.L. REV. 1 (1974). Also in support of argument by analogy from a section not literally applicable, see the summary of civil law in Beutel's *BRANNAN'S NEGOTIABLE INSTRUMENTS LAW* 98 n.67 (7th ed. 1948), referring to the use by analogy as the standard method of civil law interpretation. See also Landis, *Statutes and the Sources of Law* in *HARVARD LEGAL ESSAYS* 228-33 (1934).

100. U.C.C. § 3-802(1)(b) (1978).

101. Since the indorsement is effective (section 3-405), the transfer of the instrument results in negotiation, making the transferee a holder (sections 3-201 and 3-202). Payment to a holder discharges all obligations. U.C.C. §§ 3-601(1)(a) and 3-603(1) (1978).

significant? As to a person's own signature section 3-404 only makes effective signatures that the person whose name is used has ratified or those that the person is precluded from claiming to be forgeries. Where then do we look for the preclusion of the payee?

For the drawer there is section 4-406 embodying rules taken from pre-Code statutes existing in forty United States jurisdictions.¹⁰² Many of these statutes had a common law origin. The section creates post-payment preclusions against a drawer without regard to whether the unauthorized signature is created by an employee or a non-employee. Yet an examination of most repetitive forgeries that are precluded by the terms of section 4-406(2)(b) reveals that they are almost invariably employee-created. There is no similar provision for repetitive forgeries of a payee's indorsement except as the courts are willing to apply section 3-406 in the same manner as the California court did in the *Cooper* case.¹⁰³

One wonders at this scheme, with its emphasis on the genuineness of signatures on the part of both drawer and payee, when it is compared with the treatment of the similar problem in the case of securities, i.e., stocks and bonds. The problem is treated in section 8-205 where unauthorized signatures of both issuers and authenticators are made "effective" in favor of a "purchaser for value and without notice of the lack of authority" if the person doing the signing is "an employee . . . entrusted with the responsible handling of the security."

Yet the difference is explained by the practical difference in the course taken by the two types of instruments. The security circulates in the market, perhaps for many years. The check comes home to roost quickly to a payor with specimen signatures on file with which it can compare the writing.¹⁰⁴ Thus, the special treatment of the drawer's signature arises out of the drawer-drawee relationship where the drawee has contracted to pay out only as ordered by the drawer. A forged or unauthorized signature is not such an order unless there is ratification or conduct constituting an estoppel. Hence the post payment preclusion in favor of a careful payor is appropriate. The more appropriate analogy for the repetitive signature forgery in the case of a payee is section 3-405 as supported by the analogy from section 8-205.

What then is the proper relation and function of section 3-406 to all of this? We submit that section 3-406 was drafted primarily with external intrusions in view. The filling in by an outsider of blanks and spaces in an instrument which has been "set afloat upon a sea of strangers" can properly be left to

102. U.C.C. § 4-406, comment 1 (1978).

103. *Cooper v. Union Bank*, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973).

104. As a practical matter, items for small amounts are not manually checked by banks unless some special condition exists on the account. Rather, the electronically encoded ink data are merely read by computer and the appropriate account is charged. It would be financially impractical for a bank to check each drawer's signature to catch the minute number of drawer forgeries, and any liability which attaches from the failure to do so under the "properly payable" provision of 4-302 is written off by the payor bank as a cost of doing business. Otherwise, the service charges on all accounts would be unbearable.

a weighing of the equities approach under negligence law. This is illustrated by the difference found between making an indorsement "effective" without qualification in section 3-405 and a preclusion of the negligent party as against only two classes of persons, namely, holders in due course, a dwindling group, and payors who pay "in good faith and in accordance with the reasonable commercial standards" of their respective businesses in section 3-406.

In the case of forgeries of the payee's signature by an outsider to the payee it is reasonable not to apply the rule of negligence, as the comment states, until the payee has some notice that such forgeries are regularly occurring or by refusal to give notices prejudices any recovery by the one taking the instrument from the forger. Thus, we would restrict the application of section 3-406 to forgeries outside of the check processing operations of the person whose signature is forged.

This analysis leaves the Code without any express provision shifting the allocation of forgery losses to the payee where the forgery is internal to the payee's processing of incoming checks. The courts then must fashion a remedy from the purpose and policy underlying other sections of the Code.

No analogy has been drawn from section 4-406 because there is no return of items to the payee. Yet an analogy is there, in part, because the payee does receive a statement from the bank of deposit which should show deposits of incoming items in an amount equal to receipts of incoming checks. There does not seem to be a significant difference between the statement with checks paid that should not have been paid and the statement omitting credit for deposits that should have been made. Just as the drawer is tainted with the notice that a careful inspection would have revealed if made by a faithful employee,¹⁰⁵ so should the payee be on notice even if his system permits the abstraction of incoming checks without an internal record of receipt. Nor should a distinction be made because the bank taking the deposit on the forged indorsement is not the payee's bank, once failure to examine and investigate permits the scheme to continue.¹⁰⁶

To us, however, the more potent analogy lies with sections 3-405 and 8-205. These sections adopt a vicarious liability approach to force an employer to police, in favor of those taking checks, the nefarious activities of its employees. Courts should find this policy to be the underlying spirit and

105. See U.C.C. § 4-406, comment 7 (1978).

106. The issue is whether negligence in the payee's internal operations "substantially contributed to" the continuance of the forgeries. In *Grieshaber v. Michigan Nat'l Bank of Detroit*, 18 U.C.C. Rep. Serv. (Callaghan) 1248 (C.P. Detroit 1976), defendant's claim of negligent supervision of employee's actions in handling incoming checks was defeated by the testimony of a "consultant on bookkeeping systems" that 75 or 80% of the physicians in Detroit used the same degree of supervision. To eliminate questions of "intent" inherent in section 3-405(1)(b) and (c), and to cover wrongful intrusions during the payee processing stage, Senate Bill No. 1726, introduced in the California legislature March 10, 1982, proposes to add an item (d) to section 3-405(1) reading "an agent or employee of the maker or of the payee signs the payee's name with the intent to deprive the payee of the proceeds thereof." Proof of wrongful use of the proceeds conclusively established this intent, but the terms agent or employee are too all encompassing. As stated in the text following note 103, the scope of employment limitations of section 8-205 should be applied. If this is done, all references to intent could be eliminated.

policy of the Code in relation to employee forgery. Despite the suggestion of the Third Circuit that no line can be drawn,¹⁰⁷ we, with deference to that learned court, suggest that the key lies by analogy to section 8-205. The employee must be one entrusted with the responsible processing of the item itself or of intra-organizational papers that cause the issuance of the item. The vicarious liability rule should be applied rather than a negligence rule that would raise factual issues that are difficult to prove, namely, when a payee has received notice that its name is being forged on indorsements, and the degree of care to be used.¹⁰⁸

Admittedly this suggestion will extend the policy of sections 3-405 and 8-205 beyond the precise language used therein. But precedent exists for applying Article 2's sales warranties to lease transactions¹⁰⁹ and for the use of Article 2 provisions in transactions relating to the sale of securities.¹¹⁰ Such treatment applying the equity of the statute is invited by comment 1 to section 1-102.¹¹¹

V. CONCLUSION

We have reviewed Four Topics where some lack of clarity in the Code may be said to exist. Yet in each case appropriate solutions, consistent with the spirit and purpose of the Code, can be found. All that is required is an application of techniques that, in reality, are over four hundred years old. Authority for the adoption of the doctrine of the equity of the statute stems from *Eyston v. Studd*.¹¹² The search for the mischief to be remedied and for the true reason for the remedy provided by the statute is as old as Lord Coke's decision in *Heydon's Case*.¹¹³ The "good news" is that the Code itself, when fully examined for relevant and analogous treatment of similar problems in light of the practical banking operations to be covered, does point the way to proper solutions.

107. *New Amsterdam Casualty Co. v. First Pa. Banking & Trust Co. v. Neufeld*, 451 F.2d 892 (3d Cir. 1971).

108. See U.C.C. § 3-406, comment 7 (1978).

109. *Cintrone v. Hertz Truck Leasing & Rental Serv.*, 45 N.J. 434, 212 A.2d 769 (1965).

110. Comment 1 to section 2-105 states that although investment securities are excluded from the scope of Article 2 of the Code, in a matter involving securities where Article 8 does not deal specifically with a situation covered by Article 2, the relevant Article 2 provisions may be applied. *Tipton v. Woodbury*, 616 F.2d 170 (5th Cir. 1980).

111. Comment 1 to § 1-102 includes the statement that "[courts] have implemented a statutory policy with liberal and useful remedies not provided in the statutory text. They have disregarded a statutory limitation of remedy where the reason of the limitation did not apply. Nothing in this Act stands in the way of the continuance of such action by the courts." See also note 99 *supra*.

112. 75 Eng. Rep. 688, 2 Plowd. 459 (1573).

113. 76 Eng. Rep. 637 (Ex. 1584). The mischief rule provides that in interpreting statutes, courts must (1) look at the common law before that Act, (2) determine the mischief for which the common law did not provide a remedy, (3) determine the remedy provided to cure the mischief, and (4) make such construction of the Act as shall suppress the mischief and advance the remedy. *Id.* at 638. This, then, is the "good news" method. It provides proper solutions.